In the Matter of:

DAVID WELCH, **ARB CASE NO. 05-064**

COMPLAINANT, **ALJ CASE NO. 2003-SOX-15**

v. **DATE: May 31, 2007**

CARDINAL BANKSHARES CORPORATION,

RESPONDENT.

BEFORE: THE ADMINISTRATIVE REVIEW BOARD

Appearances:

For the Complainant:
D. Bruce Shine, Esq., Donald F. Mason, *Shine & Mason*, Kingsport, Tennessee

For the Respondent:
Laura Effel, Esq., Douglas W. Densmore, Esq., Joseph M. Rainsbury, Esq., *Leclair, Ryan Flippin Densmore,* Roanoke, Virginia; Betty Southard Murphy, Esq., Marc A. Antonetti, Esq., *Baker & Hostetler LLP*, Washington, D.C.

For Amicus Curiae American Ass'n of Bank Directors:
Arthur P. Strickland, Esq., Roanoke, Virginia

For Amici Curiae Virginia Bankers Ass'n and Virginia Ass'n of Community Banks:
Joseph E. Spruill, III, Esq., G. Andrew Nea, Jr., *Williams Mullen*, Richmond, Virginia

For Amicus Curiae American Bankers Ass'n:
C. Dawn Causey, General Counsel, Gregory F. Taylor, Assoc. General Counsel, Washington, D.C.

FINAL DECISION AND ORDER

David E. Welch filed a complaint with the United States Department of Labor in which he alleged that Cardinal Bankshares Corp. (Cardinal) violated the employee protection provision of the Sarbanes-Oxley Act of 2002 (SOX)[1] when it terminated his employment on October 1, 2002. After a hearing, an Administrative Law Judge (ALJ) concluded that Cardinal had violated the SOX and recommended that Welch be reinstated and receive back pay and other relief. But because the ALJ committed legal error, we will not adopt his recommendation, and we deny Welch's complaint.

BACKGROUND

Cardinal is a publicly-traded bank holding company subject to the SOX's employee protection section. Cardinal, which was established in 1996, is the sole owner of Bank of Floyd and its branch offices located in and near Floyd, Virginia. Cardinal and the bank share office facilities, employees, and executive staff.[2] Transcript (T) 29.

Ronald Leon Moore, who had been working for the bank since 1988, helped create the holding company and subsequently served as Cardinal's Chief Executive Officer, member and chairman of Cardinal's Board of Directors, and member of the Board's Audit Committee. Moore hired Welch as a part-time accounting officer in February 1999. About a year later, Welch asked for a full-time position as Cardinal's Chief Financial Officer, and Moore agreed. Welch is a certified public accountant and holds a masters degree in business administration. As CFO, Welch's essential duties included preparing federal, state, and local financial reports of various kinds; developing accounting control procedures; and reviewing and correcting "errors and inconsistencies in financial entries, documents, and reports." Complainant's Exhibit (CX) 35; T 245-246, 357.

The financial records and reports Welch produced included quarterly "call reports" to state bank examiners and the Federal Reserve Board and quarterly (Form 10-QSB) and annual (Form 10-K) reports to the Securities and Exchange Commission (SEC). The SEC reports contain financial information such as a statement of operations, income statement, balance sheet, statement of cash flows, and changes in capital based on

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[1] 18 U.S.C.A. § 1514A (West Supp. 2005). Regulations implementing the SOX are found at 29 C.F.R. Part 1980 (2006).

[2] Hereafter, we refer to Cardinal Bankshares and the Bank of Floyd interchangeably as "Cardinal."

shares bought and sold, as well as company commentary. A local accounting firm, Larrowe & Co., provided Cardinal with independent audits for the quarterly reports. T 42.

Welch based the reports he produced on Cardinal's "general ledgers," or "journals," where Welch and others recorded all financial transactions. Cardinal required that a witness countersign each ledger entry and that the CFO review all entries every month. Thus, every month Welch reviewed the ledger for errors and either made corrections himself or recommended corrections to Moore. CX 23.

Welch testified that he believed that Cardinal violated generally accepted accounting practices (GAAP) because Cardinal allowed people with no special accounting skills to make ledger entries. Under GAAP standards, only persons with accounting expertise should be permitted to make ledger entries. In fact, Welch testified that he wanted all but routine entries to be cleared with him in advance. CX 23; T 61. Moore, who often made ledger entries himself or directed others to make entries, would not agree to limit access to the ledger or to turn over ledger entry control to Welch. And on occasion, Moore refused to make corrections Welch thought should be made.

In the second and third quarters of 2001, Moore recorded two loan recoveries as forms of income ($45,000 in June 2001, and $150,000 in July 2001) on accounts Cardinal had previously written off. Consequently, Cardinal's third-quarter 10-QSB report to the SEC included this $195,000 in year-to-date income.[3] Welch discovered the entries during his September ledger review and told Moore that GAAP standards do not permit loan recoveries to be treated as income. Instead, they must be accounted for in the "loan reserve" account.[4] In the last quarter of 2001, Welch told Moore that the misclassification caused Cardinal's third quarter SEC report to overstate Cardinal's year-to-date income. Later, when Larrowe & Co. audited Cardinal's annual SEC report for 2001, Welch pointed out the error to Beth Worrell, the auditor in charge, and she corrected the accounting according to Welch's recommendation. CX 12; CX 23; T 49, 52-55.

Welch had other concerns besides the loan recoveries. Moore repeatedly rejected Welch's accounting advice, and Welch felt excluded from discussions between Moore and Larrowe & Co. about accounting issues. In October 2001, Welch sent Moore a memo in which he formally accused Moore of insider trading. And in March 2002, Welch filed a complaint with the SEC accusing Moore of insider trading. In June 2002,

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[3] Witnesses and the ALJ sometimes referred to the two loan recoveries as if there had been a single recovery of $195,000 during the third quarter of 2001. This is a convenient shorthand description of what happened because Welch complained about the fact that Cardinal's third-quarter 10-QSB included the $195,000 in its year-to-date income.

[4] "Loan reserve accounts" are funds that a bank holds in reserve to cover projected losses. *United States v. Whitmore*, 35 Fed.Appx. 307, 314-315 (9th Cir. 2002).

when Cardinal agreed to merge with MountainBank Financial Corporation, Welch feared that his job would be eliminated. Then, in July, Wanda Gardner, Cardinal's internal auditor, reported to the Board of Directors that Welch's system for retrieving wire transfer information was severely flawed. In August, state bank examiners found over a dozen errors in one of Welch's call reports. CX 6; CX 8; CX 24; T 38-30, 57, 110-111, 116. During the state banking review, Welch emailed one of the examiners that he, Welch, had information about "things that have gone on at the bank that I do not think are on the up and up." But neither the SEC nor the state bank examiners showed any interest in Welch's claims. CX 13; CX 14 p. 2; T 137-130, 156. Welch did not take any of these concerns to Cardinal's Board of Directors or its Audit Committee because he was afraid that Moore would fire him for doing so. T 125, 140.

Welch wrote Larrowe & Co.'s Worrell on August 2, 2002, that he would not be signing a "representation letter" she had prepared for his signature. The representation letter was a statement attesting to the accuracy, reliability, and completeness of the financial data that Cardinal was providing to Larrowe & Co. Welch was concerned that unqualified persons were making ledger entries, and he told Worrell that he could not sign the representation letter because "over the past year to year and a half, I have been excluded from your [Larrowe & Co. and Moore] communications loop almost entirely." CX 17.

Two weeks later, Welch notified Moore by memo about these same concerns and therefore would not certify Cardinal's next 10-QSB report either. CX 20. A month later, Welch followed up with a more detailed memo to Moore, elaborating on his opinion that in its 2001 third-quarter 10-QSB Cardinal had overstated its year-to-date income by $195,000 and should file a corrected report, complained that he was being excluded from the process of designing disclosure controls and procedures as the SOX required, complained that he was not permitted to address the Audit Committee or the Board of Directors, and reiterated his views that people without accounting expertise should not be making ledger entries and that Moore had engaged in insider trading. T 109, 119-120; CX 1.

Moore called a special meeting of the Board on September 17, 2002, in which he read Welch's memo and described various ways that Welch's performance as CFO had been unsatisfactory. Douglas Densmore, counsel to the Board and the Audit Committee, recommended that the Audit Committee investigate Welch's charges and that Cardinal discuss the situation with banking regulators and MountainBank Financial Corp. Venson Bolt, Chairman of the Audit Committee, asked Michael Larrowe and Densmore to investigate Welch's charges and report their findings in writing. Joint Exhibit (JX) 1.

Meanwhile, Welch scheduled a Sarbanes-Oxley "Briefing" for Cardinal managers on September 20 and consulted with an attorney on how best to make his presentation. According to an outline he prepared, Welch planned to tell the attendees that some of Cardinal's accounting practices were illegal, including treating loan recoveries as income, excluding him from Moore's consultations with Larrowe & Co., and allowing persons

without accounting expertise to make entries to the general ledger. JX 2; CX 26; Respondent's Exhibit (RX) 1; T 74-81.

He then planned to excuse everyone except Fred Newhouse, the Executive Vice President, and Marie Thomas, head of Human Resources. To Newhouse and Thomas, Welch would present the terms of a retirement package he wanted in exchange for leaving the bank "without saying anything to anyone" about accounting problems at Cardinal. He wanted a salary payment of more than one week for each year of service, the remainder of his 2001 performance bonus, full vesting of his retirement, including all of the Bank of Floyd's contributions, and a letter of recommendation. JX 2; T 144-153; RX 1.

The group convened on the 20th. Welch began by turning on a tape recorder, and when Moore asked him to turn it off, Welch refused. After explaining to the group that he had been consulting with a lawyer, Welch announced, "I tell you there's three people in this room that are parties to fraudulent acts . . . ." At that point, Moore and Battle left the meeting, and Welch continued as planned. JX 2; T 148-152.

The following week, when Densmore and Larrowe tried to interview Welch and to get a copy of the September 20 tape recording, Welch told them he did not have the tape and had not been able to consult with his attorney since the September 20 meeting. JX 6, 8, 9, 10, 11. But he told them that he had an appointment with his attorney on the following day, and would then decide how to proceed. JX 6.

When Densmore and Larrowe reported to Bolt that Welch was not willing to be interviewed because his attorney was out of town, Bolt suspended Welch with pay pending the outcome of the investigation. "We consider your refusal to meet with counsel and outside auditors to discuss matters within your area of responsibility a serious breach of your legal obligations to the company and its Board of Directors." JX 11.

After consulting his lawyer and scheduling a meeting with Densmore and Larrowe for September 30, Welch notified Densmore that he would not meet with him and Larrowe after all and would not meet with the audit committee unless he could bring his attorney. And Welch's attorney, writing to Densmore, stated that "[i]f it is your intent not to allow me to represent Mr. Welch in front of the Committee, please let me know so we can cancel the meeting." JX 18.[5]

[5] Cardinal and amici Virginia Bankers Association, Virginia Association of Community Banks, and American Association of Bank Directors argue that the ALJ committed error in holding that SOX section 1514A gives whistleblowers the right to be accompanied by private counsel during internal company investigations of their complaints and that the attorney-client privilege would not have applied to Densmore and Larrowe's interviews of Welch. Inasmuch as the ALJ did not purport to rule that whistleblowers have a right to be accompanied by counsel during internal investigations of their complaints, he did

The meeting was cancelled, and on October 1, 2002, Densmore and Larrowe presented their findings to members of the Board and the Audit Committee. Densmore and Larrowe concluded that the available information – material in Larrowe & Co. files, Welch's memos and letters to Moore, Worrell, and others, and statements from various Cardinal employees – did not support Welch's allegations. Densmore and Larrowe told the Board that if Welch really thought that Cardinal's accounting practices were deficient to the point of illegality, he had a fiduciary duty not only to tell the Board or the Audit Committee, but to cooperate unconditionally in the Committee's efforts to investigate his charges. Densmore and Larrowe recommended that the Board terminate Welch's employment immediately. By unanimous vote, the Board converted Welch's suspension into a termination effective October 1. JX 19, 20, 21, 22.

Welch then filed this whistleblower complaint. After an investigation, the Occupational Safety and Health Administration (OSHA), the Labor Department agency charged with investigating SOX whistleblower complaints, concluded that Welch's complaint had no merit. Welch requested a hearing before a Labor Department ALJ. As already noted, the ALJ concluded that Cardinal violated the SOX and recommended that Welch be reinstated and receive back pay and other forms of relief. Cardinal appealed.

JURISDICTION AND STANDARD OF REVIEW

The Secretary of Labor has delegated her authority to issue final agency decisions under the SOX to the Administrative Review Board.[6] Pursuant to the SOX and its implementing regulations, the Board reviews the ALJ's fact findings under the substantial evidence standard.[7] Substantial evidence is that which is "more than a mere scintilla. It means such relevant evidence as a reasonable mind might accept as adequate to support a conclusion."[8] We must uphold an ALJ's factual finding that is supported by substantial evidence even if there is also substantial evidence for the other party and even if we "would justifiably have made a different choice had the matter been before us de novo."[9]

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not err. And because the privilege issue is not implicated in our decision here, we need not address the question whether the interviews would have been privileged.

[6] Secretary's Order 1-2002 (Delegation of Authority and Responsibility to the Administrative Review Board), 67 Fed. Reg. 64,272 (Oct. 17, 2002); 29 C.F.R. § 1980.110 (2007).

[7] *See* 29 C.F.R. § 1980.110(b).

[8] *Clean Harbors Envtl. Servs., Inc. v. Herman*, 146 F.3d 12, 21 (1st Cir. 1998), (quoting *Richardson v. Perales*, 402 U.S. 389, 401 (1971)).

[9] *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 488 (1951).

In reviewing the ALJ's conclusions of law, the Board, as the Secretary's designee, acts with "all the powers [the Secretary] would have in making the initial decision . . . ."[10] Therefore, the Board reviews an ALJ's conclusions of law de novo.[11]

DISCUSSION

1. The Legal Standard

The employee protection provision of the SOX prohibits employers from retaliating against employees for providing information or assisting in investigations related to securities fraud:

> (a) Whistleblower protection for employees of publicly traded companies.--No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee--
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> (1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by--
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> (A) a Federal regulatory or law enforcement agency;
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> (B) any Member of Congress or any committee of Congress; or

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[10] 5 U.S.C.A. § 557(b) (West 1996).

[11] *See Getman v. Sw. Secs., Inc.*, ARB No. 04-059, ALJ No. 2003-SOX-8, slip op. at 7 (ARB July 29, 2005).

> (C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or
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> (2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.[12]

To prevail, Welch must prove by a preponderance of the evidence that: (1) he engaged in a protected activity or conduct; (2) Cardinal knew that he engaged in the protected activity; (3) Welch suffered an unfavorable personnel action; and (4) the protected activity was a contributing factor in the unfavorable action.[13]

With respect to the protected activity requirement, Welch must prove by a preponderance of the evidence that he provided information to Cardinal that he reasonably believed constituted a violation of 18 U.S.C.A., sections 1341 (mail fraud), 1343 (wire, radio, TV fraud), 1344 (bank fraud), or 1348 (securities fraud), or any rule or regulation of the Securities and Exchange Commission (SEC), or any provision of Federal law relating to fraud against shareholders.[14] Under the SOX, the employee's communications must "definitively and specifically" relate to any of the listed federal securities laws.[15]

Welch claimed that he engaged in five protected activities. The ALJ concluded that Welch engaged in three and made no findings as to the other two. Recommended Decision and Order (R. D. & O.) at 53-54. Welch has not objected so we limit our decision to the three activities that the ALJ addressed.

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[12] 18 U.S.C.A. § 1514A(a).

[13] *See* 49 U.S.C.A. § 42121(b)(2)(B) (iii) (West Supp. 2006). *See also Getman*, slip op. at 8; *Peck v. Safe Air Int'l, Inc. d/b/a Island Express*, ARB No. 02-028, ALJ No. 2001-AIR-3, slip op. at 6-10 (ARB Jan. 30, 2004).

[14] Hereinafter, we refer to these Federal statutes and SEC rules and regulations, collectively, as the "federal securities laws."

[15] *Platone v. FLYi, Inc.,* ARB No. 04-154, ALJ No. 2003-SOX-27, slip op. at 17 (ARB Sept. 29, 2006).

2. Welch Did Not Engage in SOX-Protected Activity

A. The $195,000 Loan Recovery Entries

The ALJ found that in September 2001 Welch told Moore that the loan recoveries should not be classified as income. He concluded that Welch reasonably believed that entering the loan recoveries as income was "improper" because Welch testified, and Cardinal did not dispute, that instructions for preparing a Federal Reserve call report, a form similar to the SEC 10-QSB, required that loan recoveries be reported in the "allowance account" (i.e., the loan reserve account), not in the income account. Moreover, he found that when Larrowe & Co. corrected these entries in its 2001 annual report to the SEC, Welch's concern that loan recoveries should not have been entered as income was confirmed. R. D. & O. at 55.

Because the errors in the general ledger were reflected in its 2001 third-quarter 10-QSB report to the SEC, the ALJ found that Cardinal publicly overstated its year-to-date income by $195,000. *Id.* at 56. Thus, he concluded that Welch reasonably believed that the 2001 third-quarter 10-QSB could mislead potential investors because it materially overstated Cardinal's financial status. In reaching this conclusion, the ALJ cited Welch's calculation that including the loan recoveries in the income column of the report improperly inflated Cardinal third-quarter income by 13.7%. He also noted Welch's testimony that a 21% increase in Cardinal stock prices between September 6, 2001, and October 18, 2001, had convinced him that the overstated income "made Cardinal look like it was performing really better than it was." *Id.* at 54.[16]

The ALJ rejected Cardinal's argument that because Welch had previously signed financial statements and call reports without objecting to the entries, he could not have reasonably believed that the ledger entries were improper. The ALJ found that Welch convincingly explained that he had not previously objected because, unlike the SEC report, the financial statements and call reports were not public documents that investors would see and rely upon. Welch also testified that, at the time, he still thought he could persuade Moore to change the financial statements. Furthermore, Welch explained, when the SOX became effective, he could be sanctioned for false certifications, and the new whistleblower provision would protect his employment. R. D. & O. at 57.

Michael Larrowe testified that the third quarter SEC report did not misrepresent Cardinal's financial condition. Larrowe testified that, yes, the result of the journal entries was an overstatement of income on the third quarter SEC report, but the understated loan reserve account offset the income overstatement. Therefore, according to Larrowe, the report gave a fair picture of Cardinal's financial condition – the company had $195,000

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[16] But as Cardinal points out, and the record supports, since the third quarter 2001 report was not filed with the SEC until November 14, 2001, the stock price spike between September 6 and October 18 could not have been the result of the SEC report. Rebuttal Br. at 4; RX 6.

more at the end of the third quarter than it had before it recovered the two loans. But the ALJ was "more persuaded" by Welch's testimony than Larrowe's because he found certain portions of Larrowe's testimony to be contradictory. *Id.* at 55-57.

Cardinal argues to us that Welch did not have a reasonable basis for believing that it overstated its net income. Br. at 11. To support this argument, Cardinal contends that even if the original decision to enter the loan recoveries as income in the general ledger was an accounting mistake, it does not follow that the SEC report overstated income to date. "In 2001, Cardinal collected certain bad debt in the amount of $195,000. It did not, as it should have, credit[ed] the allowance and then enter[ed] negative entries in the expense line item for 'provision.' Rather, it classified the $195,000 as forms of income. However, an entry adding $195,000 to income has exactly the same effect on the bottom line as an entry subtracting $195,000 from expenses: they both increase it by $195,000." Br. at 13. "What Welch – and the ALJ – repeatedly fail to recognize is that, with these $195,000 recoveries on previously written-off accounts, **real money came into Cardinal's door – money that was not there before.**" Rebuttal Br. at 3 (emphasis in original). "A reasonable CPA and CFO could not have concluded that there was an overstatement of net income." *Id.*

Cardinal also argues that the ALJ erred in concluding that Welch engaged in protected activity "because Welch's complaints – even if well founded (which they were not) – did not allege conduct that constituted a violation of, or even a reasonably perceived violation of federal securities laws. Conspicuously absent from the ALJ's analysis is any explanation of how the conduct complained about constituted a violation of federal securities laws." Br. at 11.

Welch Could Not Have Reasonably Believed That Cardinal Misstated Its Financial Condition

We hold that the ALJ erred as a matter of law in concluding that Welch's concerns about the loan recovery entries and the subsequent third quarter SEC report were protected. As previously noted, the SOX protects employees who report conduct which the employee reasonably believes constitutes a violation of the specified federal securities laws. The "reasonable belief" standard requires Welch to prove both that he actually believed that the SEC report overstated income and that a person with his expertise and knowledge would have reasonably believed that as well.[17] Furthermore, "[b]ecause the analysis for determining whether an employee reasonably believes a practice is unlawful is an objective one, the issue may be resolved as a matter of law."[18]

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[17] *Melendez v. Exxon Chems. Am.*, ARB No. 96-051, ALJ No. 97-ERA-006, slip op. at 27-28 (ARB July 14, 2000)

[18] *Jordan v. Alternative Res. Corp.*, 458 F.3d 332, 339 (4th Cir. 2006), *cert. denied*, __ U.S. __, 127 S.Ct. 2036 (2007).

Although the ALJ did not expressly distinguish between Welch's subjective belief and what a CPA/CFO in Welch's position would reasonably believe, his opinion implicitly makes both determinations because he wrote, "The standard for determining whether Complainant's belief is reasonable involves an objective assessment." R. D. & O. at 53.

Nevertheless, we conclude that the ALJ erred as a matter of law when he determined that Welch reasonably believed that Cardinal violated the federal securities laws by reporting inflated income in the 2001 third-quarter SEC report. After all, whether or not Cardinal misclassified the loan recoveries as income rather than crediting the loan reserve account, and whether or not stock prices increased 21% between September 2001 and October 2001, and whether or not Larrowe & Co. properly classified the loan recoveries for Cardinal's year-end 2001 SEC report, Cardinal had in fact recovered $195,000 that it previously did not have. Therefore, an experienced CPA/CFO like Welch could not have reasonably believed that the third quarter SEC report presented potential investors with a misleading picture of Cardinal's financial condition. Thus, because the "reasonable belief" test is a matter of law, the ALJ's conclusion about Welch's reasonable belief constitutes legal error.[19]

Welch's Argument About Accounting Standards

On this appeal, Welch, of course, urges us to affirm the ALJ's relevant findings and conclusions concerning his protected activity. But he also contends that when Cardinal misclassified the loan recoveries as income rather than crediting the loan loss account, it violated GAAP accounting standards and accounting rules that the Federal Financial Institutions Examination Council (FFIEC) developed for banks.[20] Welch cites a SOX provision that directs the Public Company Accounting Oversight Board ("Oversight Board") to adopt rules and other standards that require public accounting firms to evaluate whether covered companies "provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles."[21] Br. at 8, 9 Welch then writes that he "sought at all times material to assure that GAAS [generally accepted accounting standards] and GAAP standards were adhered to by Cardinal in its financial reports relied upon by the investing public. Those accounting standards, when violated, also violate the clear mandate of Sarbanes-Oxley." *Id.* at 9. Thus, Welch seems to argue that these accounting errors were ipso facto violations of the federal securities laws

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[19] *See Jordan,* 458 F. 3d. at 339.

[20] The ALJ did not make findings whether Cardinal violated GAAP or FFIEC standards.

[21] 15 U.S.C.A. § 7213(a)(2)(A)(iii)(ll)(bb) (West Supp 2006). Oversight Board rules require independent accountants of publicly traded companies to comply with generally accepted auditing standards. But the Oversight Board did not adopt these rules until 2003, long after Cardinal fired Welch. *See* www.PCAOB.org/standards/interim-standards/index.aspx.

because these standards and the federal securities laws have the same purpose – protecting investors from financial misrepresentations. Br. at 8-21.

But this argument amounts to wholesale re-writing of SOX's section 1514A. That section clearly indicates that Congress intended to protect whistleblowers who report about specifically enumerated employer conduct – violations of the Federal fraud statutes, SEC rules or regulations, or Federal laws relating to shareholder fraud. According to Welch, Congress, without saying so, must also have meant to extend protection to those employees who report violations of GAAS, GAAP, or FFIEC standards. But Welch has not supported this argument with any authority. Therefore, we reject this argument.[22]

B. Welch's Complaints About Access to Larrowe & Co. Are Not Protected

Relying on Welch's testimony and his memos to Worrell and Moore in August and September 2002, the ALJ concluded that, "Complainant reasonably believed Larrowe & Co. did not sufficiently communicate with him regarding financial matters entrusted to him by his job description but rather 'went directly to Moore and around [Complainant].'" R. D. & O. at 57. Michael Larrowe's testimony that Welch's complaints were due to a "relationship problem" and Larrowe's investigation report finding that Welch chose to play a lesser role were "unconvincing" to the ALJ because Larrowe had an interest in exonerating himself and his firm and had given inconsistent explanations for his failure to tell the Audit Committee that some of Welch's complaints were directed at his own company. *Id.* at 58. Furthermore, Larrowe's own report acknowledged the possibility that Welch's access had been restricted. *Id.* Therefore, the ALJ concluded, Welch's complaints were protected activity.

Cardinal argues that the ALJ erred in concluding that complaints about insufficient access to outside auditors are protected activity. "The ALJ fails to point to a single statute, regulation, or case that holds that an external auditor's preference for communicating with that company's CEO rather than its CFO constitutes securities fraud." Br. at 16. In fact, Cardinal asserts, "[t]he role of the external auditor is to review those reports and submissions for accuracy. It acts as a watchdog over information

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[22] *See Hall v. U. S. Dep't of Labor*, ARB Nos. 02-108, 03-013, ALJ No. 1997-SDW-005, slip op. at 6 (ARB Dec. 30, 2004) (failure to present argument or pertinent authority waives argument), *aff'd,* 476 F.3d 847, 861 n.8 ("allegations unsupported by legal argument or citation to evidentiary support in the record are insufficient to raise the specific legal theory [appellant] now alleges ARB overlooked"). *Cf.* 2A **SUTHERLAND ON STATUTORY CONSTRUCTION** § 46:4 (N. Singer, 6th ed. 2000) ("A party who asks the court to ignore the plain language of a statute must show that it is manifest that the legislature could not possibly have meant what it said in that language, or the natural reading of the statute would lead to an absurd result").

supplied by management. It does not act as a source of information to management." *Id.* at 16-17.

Welch contends that, "[i]n failing to work with Welch in providing him information to accomplish his function and comply with the Sarbanes-Oxley certification program, Cardinal and Larrowe & Company defeated the intent of the SEC and Congress that investment decisions by the public be made and based upon accurate and non-misleading financial statements." Br. at 22-23.

But Welch did not prove by a preponderance of evidence how his unhappiness about access to Larrowe & Co. constituted a reasonable belief that Cardinal was violating or might violate the enumerated fraud statutes, any SEC rule or regulation, or any federal law relating to fraud against shareholders. To be protected, an employee's SOX complaint must definitively and specifically relate to the listed categories of fraud or securities violation.[23] Therefore, the ALJ erred in concluding that Welch's complaints about access to Larrowe & Co. constituted protected activity because he does not discuss or make a finding about how insufficient access to Larrowe & Co. relates to the federal securities laws.

C. Welch's Complaints About Inadequate Internal Controls Are Not Protected

The ALJ found that the $195,000 accounting error and Moore's practice of having his secretary, Annette Battle, credit funds earned in one year to expenses incurred in a different year "were part of a pattern that suggested that Cardinal's internal controls were deficient." R. D. & O. at 60. "I find it was reasonable for Welch to believe that too many individuals without financial expertise were making journal entries without the CFO's review and that there were inadequate internal financial controls." R. D. & O. at 59. Therefore, the ALJ concluded that Welch engaged in protected activity when he repeatedly reported that Cardinal's internal controls were deficient because people without accounting expertise had unrestricted access to the general ledger.

Cardinal argues that even if Welch's complaints about internal controls were valid, they do not constitute protected activity because they do not implicate the federal securities laws. Cardinal again points out that the ALJ cited no authority to support his conclusion that its deficient internal controls caused it to violate the federal securities laws. "Although having a deficient internal control may make an institution more vulnerable to fraud, in itself it is not fraudulent." Br. at 18. We hold that the ALJ erred in concluding that Welch's complaints to Moore about inadequate internal controls constituted protected activity because, again, the ALJ did not discuss how, or make a finding that, the deficient internal control system related to the federal securities laws.

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[23] *Platone*, slip op. at 17. *See also Getman*, slip op. 9-10.

Welch argues that the internal controls themselves were not the problem. According to Welch, the bookkeeping errors about which he complained "occurred not because of a failure in the bank's internal controls, but because those controls were disregarded by Moore and resulted in the financial statements of Cardinal to be unfairly presented." In his September 20 SOX briefing to Cardinal staff, Welch explained that shareholders could be defrauded if his instructions were ignored. "[I]f you do something that [I tell you] is against the law, you're advised of it, and then you refuse to make the correction, then that could be construed as fraud. Because then it's not an accident or mistake, it becomes an intent to leave things in a deceptive state." T 74-75. Thus, because Moore did not heed his advice, Welch argues that Cardinal violated "the second purpose of the SEC to 'prohibit deceit, misrepresentations and other fraud in the sale of securities.'" Br. at 27.

We reject Welch's argument that when he complained about Moore's refusal to make the changes Welch wanted, Moore intended to mislead investors. Welch has given us no legal authority for the proposition that rejecting the CFO's advice on accounting matters violates or could reasonably be regarded as violating the federal securities laws. Nor has he explained how merely refusing to accept Welch's advice supports an inference that Moore intended to deceive shareholders.

CONCLUSION

We reverse the ALJ's conclusion that Cardinal violated the SOX because, as a matter of law, he erred in concluding that Welch engaged in SOX-protected activity. Welch's concerns that Cardinal misclassified the loan recoveries and consequently misled investors do not constitute protected activity because Welch could not have reasonably believed that Cardinal misstated its financial condition. Likewise, Welch's complaints about access to Larrowe & Co. and about Cardinal's internal accounting controls are not SOX-protected activity because they do not relate to the federal securities laws. Therefore, since Welch has not demonstrated that he engaged in protected activity, an essential element of his case, we **DENY** his complaint.

SO ORDERED.

OLIVER M. TRANSUE
Administrative Appeals Judge

M. CYNTHIA DOUGLASS
Chief Administrative Appeals Judge